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E.O. 12065: RDS 5/27/02 (MOESSNER, WILLIAM M.) OF-M
 TAGS: ENRG, EEW, SU, GE
 SUBJECT: SOVIET GAS PIPELINE: STATUS REPORT ON AEG'S
 EFFORTS TO REPLACE EMBARGOED GE TECHNOLOGY.
 REF: BONN 2879

1. C - ENTIRE TEXT.

2. SUMMARY AND INTRODUCTION:

ON MAY 25, EMBASSY ENERGY OFFICER VISITED ESSEN FOR
 DISCUSSIONS WITH AEG-KANIS, THE FRG PRODUCERS OF
 TURBINES FOR THE SOVIET-WEST EUROPEAN NATURAL PIPELINE.
 AEG, WHICH WAS REPRESENTED BY THE DIVISION MANAGER FOR
 GAS TURBINES, AND BY THE CHIEF ENGINEER FOR TURBINE
 PRODUCTION, ONCE AGAIN EXPLAINED THE DIFFICULTIES THEY
 FACED BASED ON THE U.S. EMBARGO EXPORTS OF OIL AND GAS
 TECHNOLOGY AND EQUIPMENT TO THE SOVIET UNION. AS PRE-
 VIOUSLY REPORTED, REF A, AEG IS IN DIFFICULT FINANCIAL
 STRAITS, AND THE LOSS OF THE SOVIET ORDER, COUPLED WITH
 POSSIBLE PENALTY CLAUSES, WOULD BE A SEVERE BLOW TO THE

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State Dept. review completed

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 FIRM. AS MIGHT BE EXPECTED, AEG SHOWED LITTLE UNDERSTANDING FOR THE U.S. POSITION WITH REGARD TO THE WIDER ISSUES OF EAST-WEST TRADE AND SOVIET CREDITS. THEIR CONCERN WAS SOLELY WITH THE PRESENT ORDER, WHICH THEY REPEATEDLY POINTED OUT WAS SIGNED PRIOR TO THE IMPOSITION OF SANCTIONS. THEY REPORTED THAT AEG AND JOHN BROWN HAVE DECIDED TO REJECT AN OFFER BY ALTHSON ATLANTIQUE TO PRODUCE ROTORS TO BE USED IN THE GAS TURBINES, BUT SPECULATED THAT THE MOST LIKELY SOLUTION WILL BE SOVIET PRODUCTION BASED ON THEIR EXISTING 25 MW PROTOTYPE. THESE OFFICIALS HAD LITTLE CONFIDENCE THAT THE U.S. EMBARGO WOULD BE LIFTED, AND IN ANY CASE, POINTED OUT THAT A DECISION WILL HAVE TO BE MADE BEFORE JULY 1 TO BE OF ANY USE TO THE FIRM. IN CONCLUSION THEY INDICATED THAT IT WAS THEIR UNDERSTANDING THAT THE QUESTION OF CONTINUATION OF SANCTIONS WOULD BE RAISED BY VARIOUS GERMAN OFFICIALS IN CONNECTION WITH THE VERSAILLES AND BONN SUMMITS. END SUMMARY.

3. CURRENT DELIVERY STATUS:

 AEG PRESENTLY HOLDS FOUR FRAME 5 SETS MANUFACTURED IN THE UNITED STATES AND SHIPPED PRIOR TO THE EMBARGO. THEIR DELIVERY SCHEDULE WITH THE SOVIETS CALLS FOR DELIVERY (FOB GERMAN PORT) OF TWO FRAME 3 COMPRESSORS IN AUGUST; TWO FRAME 3 AND TWO FRAME 5 COMPRESSORS IN SEPTEMBER; ONE FRAME 3 AND TWO FRAME 5 IN OCTOBER. OUR CONTACTS WERE CONFIDENT THAT THE AUGUST AND SEPTEMBER ORDERS WOULD BE PRODUCED AND DELIVERED ON TIME, BUT SAW NO LIKELIHOOD THAT SUBSEQUENT DELIVERIES WOULD BE MADE ON SCHEDULE. THEY ESTIMATE THE DELAY IN DELIVERIES IS CURRENTLY BETWEEN SIX AND NINE MONTHS DUE TO THE UNAVAILABILITY OF ROTORS. THEY NOTE THAT GENERAL ELECTRIC HAS REDUCED ITS 1982 PRODUCTION OF ROTOR SETS FROM 80 TO 42. GENERAL ELECTRIC, WHILE STILL CONSIDERING THE APPLICABILITY OF PENALTY CLAUSES, HAS APPARENTLY DECIDED NOT TO CHARGE AEG FOR ROTORS WHICH AEG CANNOT EXPORT FROM THE UNITED STATES. THIS DECISION COMES DESPITE A CONTRACT WHICH CALLS FOR THE TRANSFER OF TITLE FROM GENERAL ELECTRIC TO AEG IN THE UNITED STATES.

4. ALTHSON'S OFFER TO REPLACE GENERAL ELECTRIC:

 ALTHSON ATLANTIQUE HAS OFFERED TO INCREASE THEIR PRODUCTION OF FRAME 5 ROTORS FROM 40 (WHICH WERE TO BE USED AS REPLACEMENT PARTS) TO 98. THESE ROTOR SETS, WHICH WOULD BE PRODUCED UNDER THE FIRM'S EXISTING LICENSE FROM GENERAL ELECTRIC, WOULD IN TURN BE SOLD TO NOUVO FIGONE, JOHN BROWN, AND AEG-KANIS FOR BUILDING INTO FRAME 5 TURBINES. ALTHSON'S OFFER WILL BE OPEN UNTIL MAY 28, AFTER WHICH THE FIRM HAS RESERVED THE RIGHT TO EITHER WITHDRAW THE OFFER OR TO RAISE ITS PRICES. IN MID-MAY, AEG-KANIS AND JOHN BROWN PARTICIPATED IN A MEETING WITH THEIR GENERAL CONTRACTOR, MANNESMAN-CREUSET-LOIRE, TO DISCUSS THE ALTHSON OFFER. THERE WAS GENERAL AGREEMENT THAT THE PRICE ASKED BY ALTHSON WAS EXORBITANT; IN THE VIEW OF ONE AEG CONTACT, "IT INCLUDES ALL NECESSARY INVESTMENT TWICE OVER." AEG SAID IT REMAINED IN PRINCIPLE INTERESTED IN BUYING FRENCH-MADE ROTORS, BUT DOUBTED THE SOVIETS WILL AGREE TO THE PRICE INCREASES WHICH EXDIS

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WOULD RESULT FROM USING HIGHER COST ROTOR SETS THAN ORIGINALLY PLANNED. MANNESMAN CONFIRMED, FROM THEIR CONTACTS WITH MACHINOIMPORT, THAT THE SOVIETS WERE UNLIKELY TO ACCEPT SO LARGE A COST INCREASE. THE ALTHSON OFFER IS REPORTEDLY CONTINGENT ON THE FIRM'S OBTAINING FRENCH GOVERNMENT PERMISSION TO EXPORT ROTOR SETS USING GENERAL ELECTRIC TECHNOLOGY AND ON THE AGREEMENT OF THE FRG ECONOMICS MINISTRY TO PERMIT THE SUBSEQUENT RE-EXPORT OF THESE PRODUCTS, ALTHOUGH ALTHSON APPARENTLY HAS SOME INDICATION THAT THE FIRST OF THESE CONDITIONS CAN BE SATISFIED. ALTHSON, ACCORDING TO AEG-KANIS, HAS TO UNDERTAKE SIGNIFICANT INVESTMENT ABOVE AND BEYOND THAT ALREADY COMMITTED UNDER THE 40 ROTOR SET ORDER, IN ORDER TO PRODUCE THE ADDITIONAL ROTOR SETS ON A REASONABLE TIME SCHEDULE. (AEG BELIEVED THIS WOULD COME FROM CONVENTIONAL BANKING SOURCES AND SAW NO REASON WHY FUNDING WOULD BE A PROBLEM.) AEG ESTIMATES THAT THE OVERALL TURBINE DELIVERY SCHEDULE WOULD BE DELAYED BY AS MUCH AS TWO YEARS IF THE ALTHSON OPTION WERE CHOSEN.

5. POSSIBLE SOLUTIONS TO THE TURBINE SUPPLY PROBLEM:

MANNESMAN HAS WRITTEN TO THE SOVIETS (MACHINOIMPORT) GIVING THREE POSSIBLE SOLUTIONS TO THE PRESENT IMPASSE:

- A) WAITING FURTHER FOR THE LIFTING OF THE U.S. EMBARGO;
 - B) A DECISION TO PROCURE ROTORS FROM ALTHSON ATLANTIQUE; OR
 - C) THE FURTHER EXPLORATION OF ALTERNATIVE SOLUTIONS.
- UNDER THIS LATTER CATEGORY ARE INCLUDED: POSSIBLE POWERING OF THE PIPELINE THROUGH SERIES PRODUCTION OF A 25 MW COMPRESSOR OF SOVIET DESIGN; THE USE OF JET DERIVATIVE COMPRESSORS OF EUROPEAN ORIGIN; THE USE OF STEAM TURBINES; OR THE USE OF ELECTRICALLY DRIVEN COMPRESSORS.

6. SOVIET PRODUCTION:

AEG'S CHIEF TURBINE ENGINEER SPECULATES THAT THE SOVIETS WILL EVENTUALLY DECIDE TO CUT THEMSELVES OFF FROM WESTERN TECHNOLOGY AND TO PRODUCE THEIR OWN COMPRESSORS FOR USE ON THE PIPELINE. IN HIS JUDGMENT, THE DELAY INVOLVED WILL NOT JEOPARDIZE THE GAS DELIVERY CONTRACTS, GIVEN THE SPARE DELIVERY CAPACITY WHICH EXISTS IN THE PRESENT PIPELINE SYSTEM. SERIES PRODUCTION OF A COMPRESSOR FROM THE PRESENT PROTOTYPE WOULD BE DIFFICULT, ALTHOUGH NOT IMPOSSIBLE. THE SOVIETS ALREADY HAVE WESTERN COMPRESSORS INCLUDING GE FRAME 3'S, FRAME 5'S, AND OTHER BRANDS. THIS ENGINEER BELIEVES IT POSSIBLE THAT THE SOVIETS COULD DECIDE TO DISASSEMBLE ONE OR MORE OF THESE TURBINES TO ASSIST IN ANY ENGINEERING NECESSARY TO PRODUCE A SIMILAR COMPRESSOR ON A SERIES BASIS.

7. COMMENT: WE HAVE NO WAY OF VALIDATING THIS ENGINEER'S JUDGMENT AS TO THE LIKELIHOOD OR CAPABILITIES OF THE SOVIETS TO PRODUCE THEIR OWN TURBINE. HOWEVER, THIS SOURCE HAS HAD EXTENSIVE CONTACTS WITH SOVIET EQUIPMENT PURCHASERS AND ENGINEERS OVER THE COURSE OF THE THREE PRIOR TURBINE CONTRACTS AEG HAS HAD WITH MACHINOIMPORT.

END COMMENT.

8. ACCORDING TO OUR CONTACT, USING THE SOVIET TURBINE CF-

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 TION WOULD FREE THE SOVIETS FROM POSSIBLE FUTURE RESTRICTIONS ON IMPORT OF TURBINES OR SIMILAR PRODUCTS, AND WOULD PROVIDE THEM WITH A POTENTIALLY USEFUL PROPAGANDA COUNTER TO THE U.S. EMBARGO. LITTLE REENGINEERING WOULD BE INVOLVED. OUR CONTACT THOUGHT IT UNLIKELY THAT THE SOVIETS WOULD LICENSE THEIR TURBINE DESIGN TO A WESTERN FIRM FOR PRODUCTION IN EUROPE, AS THIS WOULD NOT PROVIDE THEM WITH EITHER THE INDEPENDENCE OR PROPAGANDA VALUE WHICH THEY SOUGHT.

11. POSSIBLE AEG ROTOR PRODUCTION:

AEG IS LOOKING INTO ONE OTHER POSSIBLE SOLUTION TO ITS PREDICAMENT. THIS WOULD INVOLVE EUROPEAN PRODUCTION OF ROTORS UNDER AEG CONTRACT, NOT DEPENDENT UPON GENERAL ELECTRIC TECHNOLOGY OR LICENSE. AEG BELIEVES THAT BY DEFENDING ON SUBCONTRACTORS TO PRODUCE THE PARTS AND EXDIS UTILIZING THEIR FIRM'S PRIOR EXPERIENCE IN ASSEMBLING FRAME 3 ROTORS, IT SHOULD BE POSSIBLE WITHIN AEG TO CONSTRUCT ROTORS FOR FRAME 5 TURBINES. ONE CONTACT BELIEVES THIS COULD BE DONE WITH LESS DELAY TO THE OVERALL CONTRACT THAN IF AEG WERE TO WAIT FOR AND USE ROTORS MANUFACTURED BY ALTHSON ATLANTIQUE. NO DECISION HAS YET BEEN MADE, AND NEITHER MANNESMAN NOR GENERAL ELECTRIC HAVE BEEN INFORMED OF THIS POSSIBILITY. AEG IS CONCERNED ABOUT POSSIBLE LEGAL PROBLEMS, BOTH WITH PATENTS PROTECTING GENERAL ELECTRIC'S TECHNOLOGY AND WITH THEIR MANUFACTURING ASSOCIATION AGREEMENTS WITH GENERAL ELECTRIC. THESE PROBLEMS ARE BEING EXAMINED, BUT IT IS LIKELY TO BE SEVERAL MONTHS BEFORE A DECISION WOULD BE MADE. THIS IS CLEARLY NOT AN OPTION FAVORED BY AEG AS SUCH AN ACTION WOULD JEOPARDIZE THEIR LONG AND MUTUALLY BENEFICIAL RELATIONSHIP WITH GENERAL ELECTRIC, AT LEAST FOR THE PRODUCTION OF FRAME 5 TURBINES.

9. JET DERIVATIVE COMPRESSORS:

JET DERIVATIVES ARE NOT THOUGHT TO BE A LIKELY OPTION FOR THE SOVIETS FOR PRECISELY THE REASONS WHICH CAUSED THEM TO BE REJECTED AT FIRST: AVAILABILITY, COST, AND REQUIRED REENGINEERING.

10. EXOTIC SOLUTIONS:

AEG HAS LITTLE INTEREST IN THE "EXOTIC" OPTIONS OF STEAM OR ELECTRIC MOTORS, ALTHOUGH THEY HAVE SUGGESTED POWERING THE LINE WITH "OFF THE SHELF" STEAM COMPRESSORS WHICH THEY MANUFACTURE. THEY THINK THIS POSSIBILITY IS UNLIKELY BECAUSE UNDER ITS GENERAL CONTRACT MANNESMAN HAS CONCLUDED SOME 26 THREE-WAY (MANNESMAN/MACHINIMPORT/EUROPEAN SUPPLIER) SUBCONTRACTS AND THAT IF SIGNIFICANT CHANGES ARE MADE IN THE METHOD OF POWERING THE GAS LINE, A LARGE NUMBER OF THESE CONTRACTS WILL HAVE TO BE RENEGOTIATED TO ACCOMMODATE THE NEW ENGINEERING. THIS WOULD BE BOTH COSTLY AND TIME-CONSUMING.

12. AEG'S PLANS:

FOR THE PRESENT, AEG SEES NO WAY OUT OF THEIR DIFFICULT SITUATION. THEIR CONSIDERATION OF POSSIBLY PRODUCING

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FACTORS IN GERMANY IS, IN THE WORDS OF ONE SOURCE, "AN ACT OF DESPERATION." THEY ARE VERY CONCERNED ABOUT PRESERVING THEIR LONG-TERM RELATIONSHIP WITH GENERAL ELECTRIC AND WOULD UNDERTAKE PRODUCTION ONLY IF THERE PROVED TO BE NO UNSURMOUNTABLE PATENT LICENSING OR PATENT DIFFICULTIES, IF EXPORT PERMISSION COULD BE OBTAINED, AND IF THIS APPEARED THE ONLY WAY TO COMPLY WITH THEIR CONTRACT. THE FIRM IS NOT CERTAIN THE SOVIETS WOULD ACCEPT THE DELAYS ATTENDANT WITH TRANSFERRING ROTCR SOURCES, ALTHOUGH SOME DELAYS APPEAR INEVITABLE AS LONG AS FRAME 5 COMPRESSORS ARE USED IN THE PIPELINE. THE DECISION POINT FOR THE FIRM WILL COME SHORTLY BEFORE JULY 1, 1982. AEG-KANIS HAS HAD TO PAY ITS EMPLOYEES AND SUPPLIERS SINCE THE IMPOSITION OF SANCTIONS LAST YEAR. THEY ALSO FACE UNCERTAINTIES REGARDING BOTH PENALTY CLAUSES IN THE SOVIET AND GE CONTRACTS, AS WELL AS THE POSSIBLE WRITE-OFF OF INVESTMENTS THEY HAVE MADE IN CONNECTION WITH THE SOVIET ORDER. (THE LATTER INCLUDES A COMPLETE UNDERLOAD TEST FACILITY WHICH THE FIRM BELIEVES IS UNIQUE TO EUROPE.) DESPITE AN EXTENSIVE MARKETING EFFORT, NO SIGNIFICANT SALES APPEAR IN THE OFFING. SEVERAL GAS TURBINES ARE BEING MADE IN HOPES OF FUTURE SALES, BUT THE FIRM IS MOST RELUCTANT TO EXPAND THEIR PRODUCTION FOR INVENTORY. FINANCING IS RUNNING OUT (HENCE THE JULY 1 DATE) AND, GIVEN THE OVERALL HEALTH OF THE PARENT FIRM, IS UNLIKELY TO BE EXTENDED UNLESS THE BANKS HAVE REASON TO BELIEVE AEG-KANIS WILL BE ABLE TO FULFILL THE SOVIET ORDER. IN THE DIVISION MANAGER'S JUDGMENT, THE BANKS WILL NOT CONTINUE TO MAKE CREDIT AVAILABLE AGAINST THE POSSIBILITY OF A LIFTING OF THE U.S. EMBARGO. HE COULD NOT SPECULATE ON THE LIKELIHOOD OF NEW PRIVATE CAPITAL SOURCES (SUCH AS THE POSSIBLE TAKE-OVER BY GEC) BECOMING AVAILABLE PRIOR TO JULY 1, BUT SAID, AT BEST, THIS WAS AN OUTSIDE CHANCE.

13. AEG'S FINANCIAL SITUATION:

THE PARENT FIRM OF AEG-KANIS, AEG TELEFUNKEN, HAS LOST FROM DM 400-500 MILLION THIS YEAR. THIS IS THE THIRD EXDIS STRAIGHT YEAR IN WHICH AEG HAS BEEN IN THE RED, AND THE PATIENCE OF THE FIRM'S BANKS IS APPARENTLY RUNNING OUT. AEG IS CONDUCTING VERY TENTATIVE DISCUSSIONS WITH A NUMBER OF POSSIBLE FUNDING SOURCES, ALTHOUGH ACCORDING TO OUR CONTACTS, NONE ARE YET BEYOND THE INITIAL STAGES. ONE POSSIBILITY, PREVIOUSLY REPORTED BY THE PRESS, WOULD BE FOR THE GENERAL ELECTRIC COMPANY (A UK FIRM, NOT TO BE CONFUSED WITH U.S. GENERAL ELECTRIC) TO TAKE OVER AN EQUITY POSITION IN AEG ANLAGENTECHNIK, THE DIVISION IN WHICH AEG-KANIS IS CONTAINED. ACCORDING TO KANIS, SUCH A POSITION WOULD ONLY INVOLVE MINORITY OWNERSHIP. OUR CONTACT AT KANIS EMPHASIZED THE EARLY NATURE OF THESE DISCUSSIONS AND SAID THAT ANY AGREEMENT WAS WELL IN THE FUTURE.

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